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Credit Issues in the Energy Markets :
Central Counterparty Clearing

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nstitutional background of LCH I

A. History and evolution of activity

- 1888 London, England – internationally-traded commodities
- 1981 Energy futures & options (IPE)
- 1982 Financial and equity futures & options (LIFFE)
- 1987 Non-ferrous metal futures & options (LME)
- 1995-2001 Cash equities (Tradepoint/virt-x and LSE)
- 1999 Government bonds and repos (various trading feeds)
- 1999 Interest-rate swaps (bilateral trading)
- 2002 More energy contracts (ICE and Endex)

Model : multi-product, multi-market clearing under one roof

nstitutional background of LCH II

3. Regulatory

1988 Recognised Clearing House under new UK legislatio

Designation and oversight : Financial Services Authority

2001 Derivatives Clearing Organization for OTC business

Designation and oversight : CFTC

Central counterparty clearing : risk management model – general

- Equilibrium : more or less no change →

  A pays B and B delivers to A (typically but not invariably through/via LCH)

- Disequilibrium : counterparty of last resort →

  A does not pay B so clearing house pays B ;

  B does not deliver to A so clearing house delivers to A

Central Counterparty Clearing : risk management model – LCH specifics I

- How does clearing house ensure it can pay & deliver in disequilibrium ?

A. Minimum standards / requirements for those whose risk it underwrites (membership / participant standards)

B. Market risk protection (margining, re-valuation, contingent resources)

C. Legal framework (clarity of contractual privity, product contract terms, rulebook, default rules, insolvency protection)

Risk management model – LCH specifics II

≡ Membership / participant standards

A. Minimum capital) general comment :
B. Market and settlement expertise) clearing is cash
C. Banking facilities) & collateral
D. Settlement facilities) intensive

NB: LCH membership requirements allow participation by specialist trading or commodity companies as well as financial intermediaries

Risk management model – LCH specifics III

- Market risk protection

A. Measurement of latent market risk → initial margin (IM) requirement collected from members (total LCH IM $16bn)

B. Intra-day and end-of-day re-valuation → collection of losses and additional initial margin

C. Further contingent financial resources → Default Fund (cash only : $540mn) contributions from members + default insurance ($320mn) + own capital ($120mn)

NB (i) Initial margin requirements and additional ‘delivery margin’ tailored to obligations linked to specific contracts
(ii) In the event of member default, only the defaulter’s initial margin can be used, not that of non-defaulters. The ‘mutualised’ resource is the Default Fund – the defaulter’s contribution to which would be used first.

Central counterparty clearing : risk management model – LCH specifics IV

- Legal framework
  - LCH and members contract as principals (no privity with any clients)
  - Contractual and rulebook reinforcement of rights and obligations
  - Robustness of netting, right to offset and certainty of access to margin
    - UK Companies Act 1989 (1998)
    - US Bankruptcy Code
    - UK FMIR 2000 → EU Settlement Finality Directive